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Investing in Montenegro: Limits and Opportunities

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Abstract

Over the past few decades international flow of capital has contributed to the “globalisation” phenomena. Some countries took advantage of this, managing to develop their economies and to improve the standard of living of their citizens by attracting foreign investments. Others were not so successful. Countries of the South-Eastern Europe, hit by Balkan wars and economic sanctions, were late to be included in the first wave of international capital flow. But now, when the whole region tries to join the accession process to the European Union, foreign investments are more important than ever. This paper examines one such country – Montenegro, which suffered for almost two decades, isolated by economic sanctions and hit by the consequences of the Balkan wars. Montenegro is a part of the State Union of Serbia and Montenegro and it undertook extensive economic and social changes in order to fulfil the conditions for accession into the European Union. This paper presents general information for foreign investors interested in this part of Europe and describes specific benefits and risks that they may face during the process. There are many possibilities that can be exploited by educated investors not afraid to invest their capital in Montenegro.

Key Words: International flow of capital, foreign investments, Montenegro, accession, foreign investors

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1. Introduction

There are a variety of reasons why companies invest in foreign countries. Historically, one of the first reasons was to set up subsidiary companies in foreign countries in order to penetrate and conquer new markets. This was done with the aim of overcoming import restrictions, trade and foreign exchange regulations, customs and other obstacles, to continue their growth and to increase their income and profit. These were all reasons for companies to invest in foreign countries and that method of conducting business was, at the time, easier than to export to that particular country when foreign companies would be exposed to domestic government's restrictions and regulations designed to protect domestic companies.

In recent economic theory different reasons were presented as explanations for international investments. For example, M. Sass (2003), presenting different economic theories, stated that international production is the result of a process affected by specific advantages. Sass claims that localisation is the most important advantage on which an investor selects a location for a project, and numbers other factors as availability of local inputs, the size of markets, location, economic policy of the government, factor prices, transport costs, the position of the economy etc.

However, for the majority of modern economists diversification is stated to be the most important reason that drives investors to invest in foreign countries. Domestic markets may look safer but for investors seeking growth, emerging markets may be much more interesting. The findings of Bodie et al (2005) support the assertion that global diversification offers opportunities for improving portfolio risk-return trade-offs. Investors that have a large "low risk-low return" portfolio may invest some funds in emerging markets that have a higher growth rate and consequently improve their return.

At this point, Montenegro, as a part of the State Union with Serbia and other South-Eastern European countries, is in particular need of foreign investment. Ravaged by years of war and economic and political sanctions, Montenegro and Serbia saw a dramatic decline in output with severe damage to traditional industries. All of this resulted in a fall of the standard of living and economic activity. D. Jacimovic (2004) noted that the level of domestic savings is not enough to serve the recovery of the economy in any of Balkan (South-Eastern European) countries and drew the conclusion that direct foreign investments are needed.

After wars and sanctions were over, those countries, like other countries that emerged from the former Yugoslavia and Eastern Block, started to transition their economies from a centrally planned communist style into market economies. But, because of political problems in the past and the poor state of their economies, these countries do not have good credit ratings. These problems joined with foreign exchange risk, former capital flow restrictions across the national boundaries, different accounting practices, differences in a legal system and specific environmental protection regulations constitute considerable country risk for potential investors.

Despite all of this, some foreign investments and privatizations of state owned companies are well under way. The process of the transformation of the legal system into one that is in accordance with European directives is almost completed. It seems that this is the right time to attract more investments and to establish new economic links. Such links will give a much-needed boost to the economy, improve the current standard

of living, which is the most significant issue at this moment, and strongly push the country forward in the accession process. This path will prevent South-Eastern European countries from reverting back into nationalistic and militaristic regimes.

Research work on issues of investing in this part of Europe should provide a platform to form an international basis for bringing Montenegro and Serbia and other South-Eastern European countries closer to the developed countries of Western Europe. The overall goal of this paper is to facilitate the decision making process of potential investors who are considering expanding into Montenegro and to provide necessary insight and information, as well as policy recommendations.

This paper is divided into several parts. The first part will present some important general data on foreign investments. This part will present the current situation in selected countries as well as data on FDI flow in the recent period. The second part will provide a basic analysis of risks related to foreign direct investments. The third part will concentrate on the Republic of Montenegro as a potentially attractive country for investments and will present the author's views on why he believes it is. It will also number some policy recommendations for local authorities and for foreign investors. Finally, concluding remarks will encompass all that was said in the paper into a concise and logical conclusion of the research.

2. Foreign Investments

Capital flow across the borders usually takes one of three forms. It can be in the form of a "loan capital", foreign direct investments or portfolio investments. Loan capital represents granting of loans across the border to a foreign nation or a company based in a foreign country. Foreign direct investment (FDI) is usually defined as investment in productive assets by a company incorporated in a foreign country. Investments in shares are considered to be portfolio investments. For portfolio investments it is necessary that the country recipient of investments has a developed and functioning financial market, that is, capital and money markets. With the increase of an inflow of direct investments the level of total investments in the country rises. D. Jacimovic (2002) cites empirical evidence that even when the foreign investments substitute domestic investments they are more productive than the capital they substitute. At the same time they contribute to the rise of productivity of the domestic investments and capital as well as increasing the growth of domestic investments. Although this definition is a solid illustration of the nature of foreign direct and portfolio investments, further definitions will be used in this paper, as data presented in the text are based on definitions given by IMF.

IMF in its "**Balance of Payments Manual: Fifth Edition**" (BPM5) (Washington, D.C., International Monetary Fund, 1993) defines that *"FDI refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor. Further, in cases of FDI, the investor's purpose is to gain an effective voice in the management of the enterprise. The foreign entity or group of associated entities that makes the investment is termed the 'direct investor'. The unincorporated or incorporated enterprise-a branch or subsidiary, respectively, in which direct investment is made-is referred to as a 'direct investment enterprise'. Some degree of equity ownership is almost always considered to be associated with an effective voice in the management of an enterprise; the BPM5 suggests a threshold of 10 per cent of equity ownership to qualify an investor as a foreign direct investor."*

In economic literature, authors have explored a number of benefits to the recipient countries of international capital flow through direct investments, for example, D.

Jacimovic (2002) cites Marsden (1989) who lists the following benefits of direct investments:

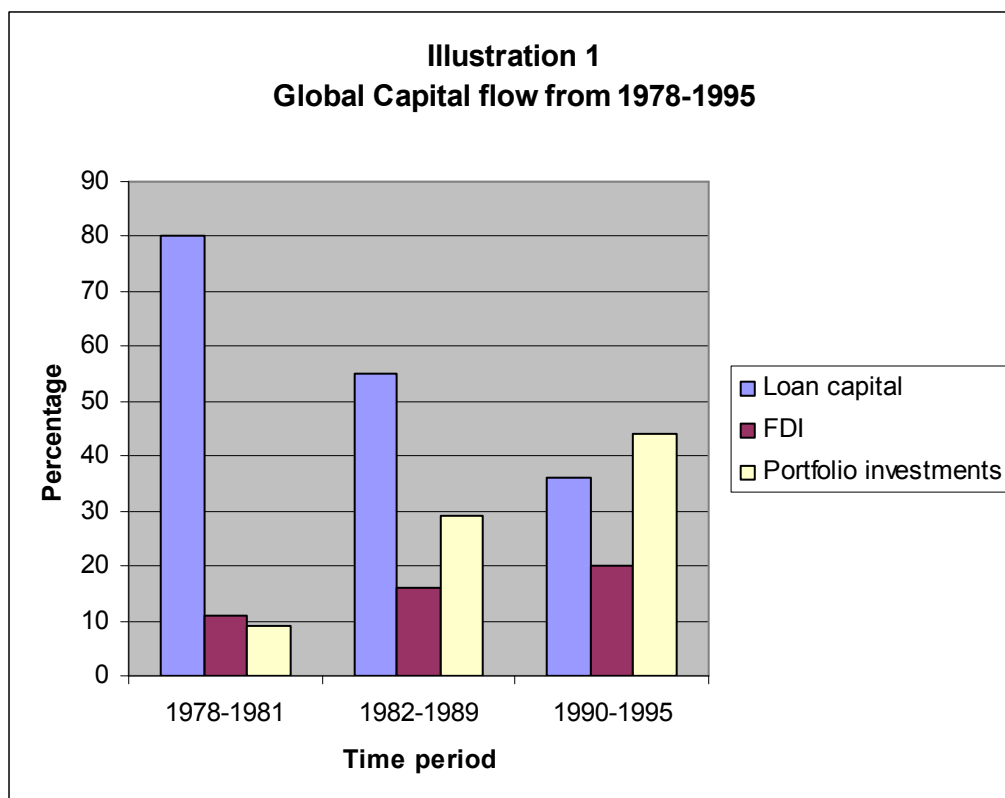
1. Additional inflow of capital
2. Transfer of technology
3. Access to managerial skills
4. Creation of new jobs
5. Access to international market and to modern marketing
6. Decrease of the outflow of domestic capital (“running away”)
7. More rigorous measures for the selection of investment projects and the decrease of the number of inefficient and less profitable projects
8. Introduction of new equipment and business practice
9. Long-term engagements of foreign investors
10. Foreign direct investments serve as a catalyst to attract all other types of capital inflow and to increase the availability of foreign financing.

However investors are not normally concerned with the advantages for the recipient country. They are more concerned with ascertaining whether it is more profitable to invest in a foreign country or not, that is, whether the country provides conditions which are attractive enough to invest.

The division of international capital flow to loan capital, foreign direct investment and portfolio investment was presented earlier in this paper. In the last 30 years these different types of international capital flow recorded a change in their participation in the global capital flow.

As Prakash Loungani and Assaf Razin (2001) showed in their paper, contrary to the period from 1978 to 1989, loan capital is reducing its participation in the flow of capital over the world and portfolio and direct investment participation is growing. They considered three periods 1978-1981, 1982-1989 and 1990-1995 and determined that loans declined from 80% in the first period to 55% in the second period and to 36% in third period. During the same time periods, portfolio investments rose from 9% in the first period to 29% in the second period, and to 44% in the third period. Foreign Direct Investments rose from 11% in the first period to 16% in the second period, and to 20% in the third period.

The following illustration gives a vivid presentation of these figures and shows how much international capital flow shifted from loan capital to direct and portfolio investments.



As for the future of global investing there are a number of predictions that take into account opinions of investors, analysts and economists. A group of contributing authors in UNCTAD (2005) concluded that *“Prospects for global foreign direct investment (FDI) are promising in both the short term (2005-2006) and the medium term (2007-2008). Although there are some potential risks, which may weaken momentum in the near future, FDI growth is likely to continue in the years to come. The recovery is increasingly fuelled by investment into, and from, developing countries. The overall mood is one of cautious optimism.”*

It was also concluded that *“The Global Investment Prospects Assessment 2005-2008 presents the future trends of global and regional FDI flows, strategies of Trans-National Corporations (TNC) and developments of FDI policies. The Assessment is based on the findings of three worldwide surveys (i.e. the surveys of the world’s largest TNC, national investment promotion agencies and international investment experts); as well as on the analysis of relevant leading economic indicators, and policy developments that would shape future FDI patterns.”*

2.1. Cost/benefit analysis

If an investor considers entering another country then he has to take into account all costs, which are different from the costs he incurs in the domestic market but are related to the investing process. When going into another country he encounters entry costs, business running costs and exit costs. Entry costs are all the costs associated with crossing the border that the investor does not incur in his domicile country. Transport costs, custom duties for imported machinery and other necessary items, costs of registering a new company or subsidiary in foreign country are among the costs that an investor would not incur if he just decided to invest in his domicile country.

On the other hand the costs of running the business should be much lower since direct investments in a foreign country are usually attracted by lower work force costs, lower

taxes and other incentives foreign governments may give to attract investments. Finally, a foreign investor likes to have the opportunity to exit from the country and to transfer back his funds. This may cause additional costs that governments set up in order to discourage outflow of capital. Exit costs are also related in economic literature with costs of firing and hiring the local work force.

Therefore, the investor must earn a larger income than the sum of the afore-mentioned costs plus additional risks premiums for market risk, operational risk and country risk. His costs must be lower than business running costs in his country in order to be competitive or the revenues must be higher to cover these costs and provide higher return for the investor than in his domicile country. Generally speaking the main historical reasons for investing in foreign countries was exploitation of lower costs of raw material, work forces and lower taxes.

Montenegro is currently in a State Union with Serbia and is one of the South-Eastern European (SEE) countries. The SEE countries are: Romania, Bulgaria, Albania, Serbia and Montenegro, Macedonia, Bosnia and Herzegovina and Croatia¹. The European Union has already started negotiations with Romania and Bulgaria on the accession process. The rest of the countries are considered as West Balkans area that will probably come later to the agenda of European Union accession.

Romania and Bulgaria were part of the Warsaw Pact and with some differences these countries made a lot of progress in their path to accession in European Union. They started negotiation processes earlier and it is to be expected that these two countries will become part of the EU before the remaining countries. Except Albania, all other countries were part of the former Yugoslavia. But, generally, as D. Jacimovic (2004) noted, the level of domestic savings is not sufficient to serve as the basis for reorientation of the economy so the attraction of foreign investments is the priority.

As emphasized in UNCTAD (2004) World investment report, countries that joined EU full membership need to adopt the full body of the EU Law (the *acquis communautaire*), which on one hand improves the business environment and the attractiveness of accession countries but on the other hand it may increase the cost of doing business (for example, compliance with labour standards or environmental protection). That is what all accession candidate countries must bear in their minds. This is all further complicated by bilateral agreements that accession candidate countries may have with third parties like USA. These Agreements had a great impact on the reconstruction of their economic and political systems but may be not in accord with EU international agreements.

After the Balkan wars in the 1990's these countries received considerable foreign help for the transition into market economies. That is why these countries have already built a legal and political system that provides them with the opportunity to join the EU after fulfilling sustainable market economy conditions.

Statistics on direct investments in mentioned countries for the period up to 2002 are given in the following Table given by D. Jacimovic (2004) and updated with input of data for 4 countries from UNCTAD report (2004):

¹ Greece is already in the European Union and although geographically part of the region it is not included. Turkey may be considered as a part of the region but because of its differences in comparison to other mentioned countries (size, population and the fact that bigger part of the country is in Asia) it is not included in this paper.

Table 1 : Inflow of foreign Direct Investments in South-Eastern Europe from 1991 to 2002 in millions of US dollars (2003 data added by author)

	1991-1996*	1998	1999	2000	2001	2002	2003
Albania	58	45	41	143	207	213	178**
Bosnia and Herzegovina	-1	56	154	147	130	321	
Bulgaria	74	537	819	1,002	813	479	1,400
Croatia	216	932	1,467	1,089	1,561	981	1,700
Macedonia	15	118	32	1,777	442	77	99***
Romania	206	2,031	1,041	1,025	1,157	1,106	1,600
Serbia and Montenegro	66	113	112	25	165	475	1,400
Total	370	3,832	3,666	5,208	4,475	3,652	

*Note: for the period 1991-1996 given data represents the average value. Data for Albania and Romania are estimates.

Source: UNCTAD, FDI/TNC database (2003 data)

** Source: INSTAT, Albanian national statistics agency (in millions of dollars)

*** Source: National Bank of the Republic of Macedonia

The following provides practical notes for potential investors who have not previously invested in foreign countries. This could also benefit investors who have already made investments but were not successful because culture gaps were not taken into account before the investments. Foreign investors should do their research before coming into one of the mentioned countries and that should be particularly applied to simple every day problems, as they should not try to resolve everything in the same manner. The same problems in similar countries may require completely different approaches. This is why I personally like to paraphrase that old proverb: “If the hammer is the only tool available, suddenly all your problems will start to look like nails!”

In order to avoid mistakes in resolving every day problems, one of the first things investors should do is to hire competent local staff that have been exposed through education or through work engagements to the foreign country’s laws and practices. If there is no local staff available on the job market with the required skills then the investor should provide funding for local students or professionals to obtain such education abroad. It is essential for a foreign investor to have quality local staff. They should also hand pick experts they are sending in a particular country because their attitude may help or burden relationships with locals (including employees, government officials and other).

3. Risks

As mentioned before, there are different reasons why investors invest beyond the national borders. But as in domestic investments the main driver is potential profit. So, expected return on investment for potential investors in foreign countries should be

higher than in the domestic market. Also by default that means that the risk of such investment will be higher than the risk of doing business on the domestic market.

Since sentiment for investments is an important factor in investing as an activity, let us begin by presenting some findings of a survey conducted by UNCTAD.

UNCTAD (2005) performed a comprehensive study on Prospects for global foreign direct investment (FDI) and found that: *“they are promising in both the short term (2005-2006) and the medium term (2007-2008). The overall positive outlook, indicated by the Global Investment Prospects Assessment (GIPA) 2005 surveys and the business environment depicted by various leading indicators for FDI, all point to increased investment in the future. The stage for the expected FDI growth is set by the foreseeable macroeconomic climate, which is largely favourable to FDI, and growing corporate profits that increase the availability of funds available for investments for future corporate expansion. Furthermore, investment liberalisation continues apace at both national and international levels. Competition to attract FDI through various promotion and facilitation measures has also escalated further. All this has set the scene for increased FDI flows over the next few years.”*

This part will define the most important risks faced by the investor who invests internationally; country risk, currency risk, market risk and operational risk.

3.1. Country Risk

Before coming into a foreign country a prudent investor will certainly conduct an appropriate risk/return analysis. Bodie et al (2005) presents “country-specific risk” emphasizing that security analysis at the macroeconomic, industry and firm specific level is similar in all countries and that analysis aims to provide estimates for expected returns and risk of individual assets and portfolios. But to achieve the same quality of information about assets in a foreign country is by nature more difficult and more expensive.

The one risk that must always be the top priority for an investor seeking to invest internationally is the country risk. Lakic (1996) presents that country risk is related to a set of risks originating from the economic, social and political environment of a certain country (including policies of the government created to deal with events in these environments) which has potentially favourable or unfavourable consequences to the foreign debt and/or invested capital in such a country.

Country risk, therefore, in economic theory is considered as the risk that a certain country will not be able to fulfil its obligations. For an investor, country risk is the risk of incurring losses because of political, social and economic conditions in the country where funds are invested. A part of country risk can also be a risk of transferring the money out of the foreign country because of the inability of collections of claims denominated in the money that is not legal tender in that country (usually it is country-debtor). Therefore, the only way to collect debts is in the local currency with a possibility of devaluation before the money is converted in dollars or other convertible currency.

International rating agencies only recently started to rate country risk for Montenegro. The Ministry of Finance (MOF) of the Republic of Montenegro published information that the Republic of Montenegro was rated ‘BB’ by the Standard and Poor’s rating

Agency with stabile outlook.² D. Jacimovic (2004) presented EUROMONEY ratings of Balkan (South-Eastern European) countries with the following results:

Table 2: EUROMONEY ratings of SEE countries (September 2003)

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	Macedonia	Romania	Serbia and Montenegro ³
Rank	122	131	68	59	106	72	136

Analysis in this paper concluded that foreign investments are attracted by a stabile macro economic environment, by the speed of economic reforms, by good quality institutions that encompass the rule of law and control of corruption, and the good rating of the country (lower “country risk”).

Table 3: Country Risk ratings by COFACE North America⁴

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	Macedonia	Romania	Serbia and Montenegro
Rating	D	D	B	A4	C	A4	C

Table 3 shows ratings to selected countries given to them by Coface North America. These ratings are given in 2004, and are available on the web site of this company. In this paper they are shown just as an example of ratings given to the selected countries by international ratings agencies. The following presentation of two key macro-economic indicators may provide a good picture for potential investors in this region (data for Montenegro are given in the next part).

Table 4 below avoids absolute numbers when presenting data on selected countries since those countries vary considerably in size of territory and in population. Both indicators of economic performance are given as relative changes over the period of 4 years. This should give an indication to educated investors of the trends of these two macroeconomic indicators. If we take a look and compare this data to data given for Montenegro we can conclude that Montenegro is doing better than some of its neighbouring countries.

² STANDARD&POOR'S Credit Rating, Sovereigns, “**Republic of Montenegro Outlook revised to positive on reform progress; ‘BB’ LT Rating Affirmed**”, reprinted from Ratings Direct, published 21-Dec-05 available at MOF web site.

³ This rank is applied to the State Union of Serbia and Montenegro (SAMN).

⁴ Coface North America is a unit of the Coface Group, a world leader in trade-risk management, serving 85,000 clients in 93 countries worldwide. Leveraging nearly 60 years of experience and a database of 44 million companies, Coface sets the global standard in assessing creditworthiness and protecting companies worldwide against the risk of non-payment.

Table 4: Basic macroeconomic indicators for selected countries

Country	Indicator	2002	2003	2004	2005
Albania ⁵	GDP growth	4.3	5.7	6.7	n/a
	Inflation rate ⁶	n/a	2.4	3.4	n/a
Bosnia and Herzegovina ⁷	GDP growth	n/a	4.0	6.2	n/a
	Inflation rate	n/a	1.5	2.9	n/a
Bulgaria ⁸	GDP growth	4.9	4.5	5.6	n/a
	Inflation rate	3.8	5.6	4.0	6.5
Croatia ⁹	GDP growth	5.2	4.3	3.8	n/a
	Inflation rate	1.7	1.8	2.1	n/a
Macedonia ¹⁰	GDP growth	0.9	2.8	4.1	n/a
	Inflation rate	1.1	2.6	-1.9	n/a
Romania ¹¹	GDP growth	5.1	5.2	8.3	n/a
	Inflation rate	22.5	15.3	11.9	n/a
Montenegro ¹²	GDP growth	1.7	2.3	3.7	4.5
	Inflation rate	9.4	6.7	4.3	1.8

*Indicator GDP growth is presented as the annual change expressed by percentages in comparison to previous year

**Indicator Inflation rate is presented as the annual change expressed by percentages in comparison to previous year

The legal and economic system of Montenegro is in a high degree of accordance with European Union directives and with best practices in the world, since USAID and European Union funded economic and social transition in this part of the world engaging experts from all over the world in this process.

One dimension of the country risk experienced by foreign investors in Montenegro is related to changes in the government's policy over agreed terms of contracts. As the Financial Times (2005) reported, the Norwegian company TELENOR had such an experience, since it reached a deal with Montenegrin authorities in 1996 allowing the company to establish PROMONTE, the country's first commercial mobile operator. Company chiefs at the headquarters in Oslo celebrated the state's promise of a 20-year monopoly - a highly valuable asset in the fast-evolving mobile sector at a moment when western operators were descending in force upon Eastern Europe. But in 2000, TELENOR executives were shocked to learn that the same state officials had changed their minds and granted TELEKOM, the country's fixed-line monopolist, then state-owned, a licence to launch a rival mobile operator, Monet. TELEKOM CRNE GORE

⁵ Source: web site of the Bank of Albania <http://www.bankofalbania.org/>

⁶ Source: web site of EU- http://europa.eu.int/comm/enlargement/albania/economic_profile.htm

⁷ Source: the World Bank, data for Bosnia and Herzegovina, http://devdata.worldbank.org/AAG/bih_aag.pdf

⁸ Source: web site of the Bulgarian National Bank <http://www.bnb.bg/bnb/home.nsf/fsWebIndex?OpenFrameset>

⁹ Source: web site of the Croatian National Bank <http://www.hnb.hr>

¹⁰ Source: web site of the National Bank of the Republic of Macedonia <http://www.nbrm.gov.mk>

¹¹ Source: web site of the National Bank of Romania http://www.bnro.ro/def_en.htm

¹² Sources of data are given in further text.

held a 9 per cent stake in PROMONTE, so its surprise decision to compete directly with PROMONTE further startled TELENOR'S executives. PROMONTE immediately found its market dominance and prices undercut by Monet, and a bitter legal dispute erupted after the state officials' refusal to adhere to their previous agreement.

As the Financial Times (2005) further reported TELENOR faced a classic switcheroo of a kind many foreign investors have stumbled into in Eastern Europe, where some state officials invite private investment but, once they arrive, view them above all as easy targets for taxation. The company's position was unenviable. It had invested heavily in Montenegro's new mobile communications infrastructure, so a total withdrawal from the market was unattractive. At the end of 2001, the General Manager of PROMONTE sued for peace, reaching an out-of-court settlement with the state. In the deal, PROMONTE agreed that Monet would be allowed to continue operating, but TELEKOM CRNE GORE would sell off its 9 percent stake in PROMONTE, which would receive a new operating licence from the state authorities. In the wake of this deal, PROMONTE now controls a 58 percent market share in Montenegro, a country where 80 percent of the population uses a mobile telephone.

Some state economists explained this development of events by stating that the government had to carry out such changes in order to comply with anti monopoly legislature of European Union, in accordance with it's policy of making Montenegro a member of the EU. The Financial Times (2005) in its report presented that the lesson of PROMONTE'S recent dispute with state officials is that "personal deals" are the key to smooth business operations in Montenegro, a country where some investors find the rule of law to be disappointingly weak.

Some investors also may find obstacles at the local government level in Montenegro. The above mentioned mobile phone operator was faced with a huge increase in local taxes and fees for usage of the public property¹³. This was one of the reasons for the Government of Montenegro to revise and to pass amendments to the Law on Local Communal Fees.

3.2. Currency Risk

Operating in another country means that an investor has to take into account currency risk since, for example, the volatility of domestic currency may expose an investor to a high risk of losing on the currency exchange. This is the risk that a business' operations or an investment's will be affected by changes in exchange rates. For example, if money must be converted into a different currency to make a certain investment, changes in the value of the currency relative to the domestic currency will affect the total loss or gain on the investment when the money is converted back. This risk usually affects businesses, but it can also affect individual investors who make international investments. This risk is also called exchange rate risk. The investor has to bear in his mind that possible devaluation of local currency may wipe out profits, and revaluation may increase production costs to an unacceptable level. Investors should take into account the relation between exchange rate and interest rates in different countries. That is because they are connected and often present a target for arbitrageurs.

¹³ These taxes are not aimed on only this company but also its competitor and other companies that use public property under the local government jurisdiction (although some say only reach companies).

Since the official currency (legal tender) in Montenegro is the Euro, this makes currency risk acceptable and manageable to most investors. However, there are two more risks that need to be taken into account and those are interest rate risk and inflation risk. These two risks in relation to Montenegro are presented in more detail in the next part of this paper.

3.3. Market Risk

This risk also exists in a domicile country, but in a foreign country it may not be quantifiable in the same manner. It may be a lot higher than in the domicile country, but sometimes, even lower. It is a fact that domestic companies would probably have an advantage over an investor regarding the knowledge of market risk. Market risk is common to an entire class of assets or liabilities. The value of investments may decline over a given time period simply because of economic changes or other events that impact large portions of the market. Asset allocation and diversification can protect against market risk because different portions of the market tend to under-perform at different times. This risk is also called systematic risk.

What most investors are concerned with in regard to a foreign market is the competition they face in that market. Domestic companies in Montenegro are really too small and do not represent a competitive force to reckon with for international investors. The biggest competition will be other foreign investors that would also try to benefit from comparative advantages of Montenegro. There are already a number of investments in Montenegro that will be presented later in this paper.

3.4 Operational Risk

Basel Committee on Banking Supervision (2005) defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk (legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements) but excludes strategic and reputation risk. This is the type of risk that is not related only to investments in financial institutions but to all investments where an investor sets up or acquires the running of a business using existing employees and operations systems.

Operational risk may be effectively reduced by imposing management practices from developed countries. Therefore, it would be ideal to set up in the first period a team of managers from developed countries and gradually educate and train the local work force to build their skills up to the standards of modern market economies.

4. The Montenegro Case

Montenegro was a part of the former Yugoslavia. Today it is a Republic and a part of a State Union with Serbia. Montenegro has an area of 13812 km² and a population of 620,000 (according to 2003 census). Capital is Podgorica, which has a population of 180,000. It is situated at the Adriatic Sea across Italy and has a border with Croatia and Bosnia and Herzegovina on the West and Albania on the East. On the North of Montenegro is Serbia. There are two International airports (Podgorica and Tivat) and several international sea ports (Bar, Kotor, Zelenika, Tivat). Montenegro is connected to neighbouring countries by roads and railways too.

Investors seeking to invest in foreign countries monitor the state of global economy but they also follow closely the macroeconomics of the target country. Bodie et al (2005) lists some of the key economic statistics used to describe macro economy. Gross Domestic Product (GDP) is the measure of the economy's total production of goods and services and for an investor it is important to know whether it is growing or declining, because a rapidly growing GDP may indicate an expanding economy with ample opportunity for a firm to increase sales.

The following table uses data from World Bank (2005) and ISSP (2005) to present changes in Montenegrin GDP for the period from 2000 to 2005.

This period was chosen because of two reasons: first Montenegro introduced the German Mark as legal tender and converted to the Euro during this period, which gives solid comparable monetary measures, contrary to the period before which was highly distorted by hyper inflationary movements of DINAR (former legal tender in Yugoslavia, that is, Montenegro as part of Yugoslavia).

Second, during this period Montenegro went under significant transformations of legal and economic systems that included new banking, financial system, accounting and other relevant laws that provided statistical measures comparable to those in developed countries.

Table 5 Annual changes of GDP of Montenegro in %

	2000	2001	2002	2003	2004	2005
GDP	1022.2	1244.8	1301.5	1433.0*	1535.0*	1604.0***
GDP annual changes in %	3.1	-0.2	1.7	2.3**	3.7	4.5***

* Data calculated by World Bank and MONTSTAT (State Statistic Office)

** MONTSTAT estimated 2.3% GDP growth for 2003, but ISSP assessed it was only 1.5%

*** GDP for 2005 assessed by ISSP

The unemployment rate is the percentage of the total work force out of job in the country and it can serve to measure the extent to which the economy is operating at full capacity. Montenegro has one of the highest unemployment rates in the region. The main reason for this is the lack of demand in the labour market.

This demonstrates the small capacity of the domestic economy to create new jobs, but on the other hand provides an opportunity to potential investors to find a highly qualified work force available at comparably lower prices than in surrounding countries. The unemployment rate in Montenegro declined from 37.4% in 2000 to 31.2% in 2004 according to the ISSP assessment made on the basis of the official data.

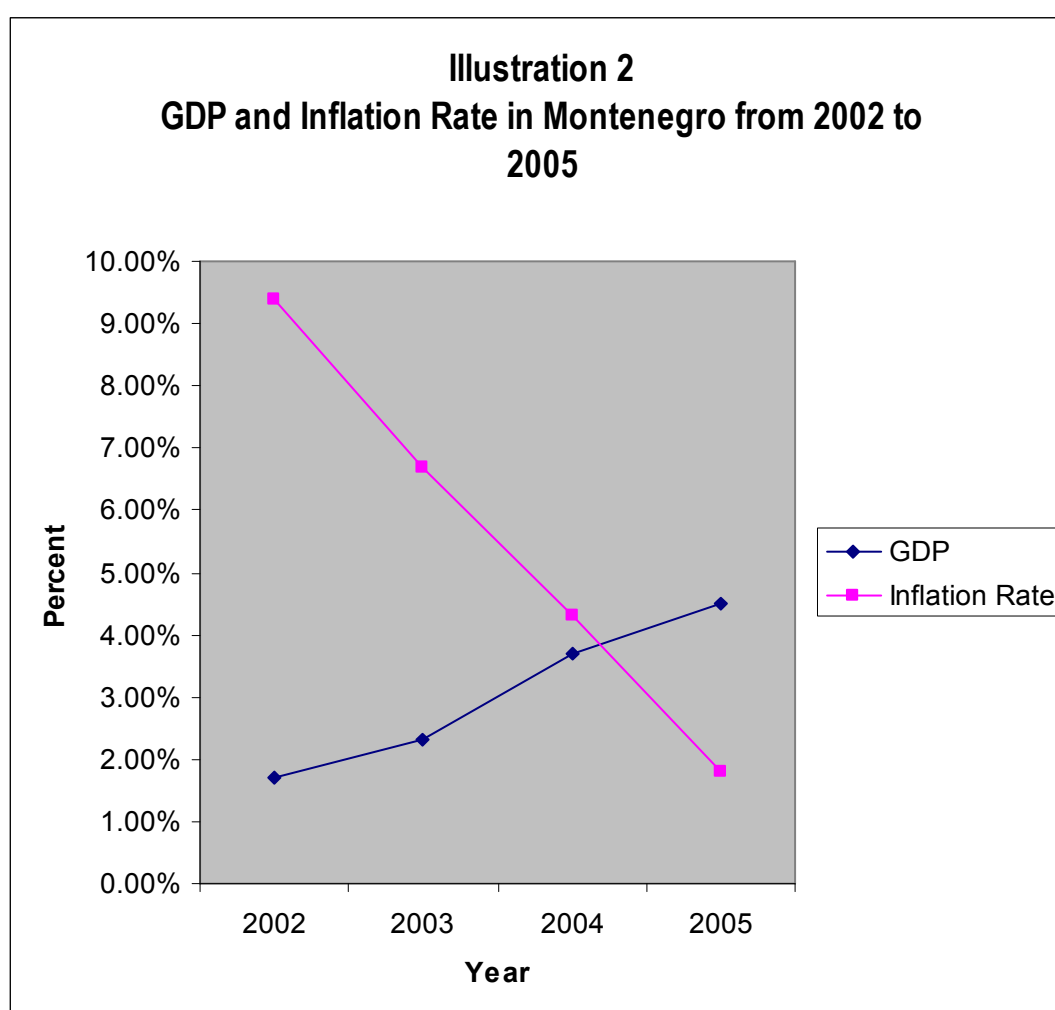
Inflation had historically very high levels in former Yugoslavia breaking all records during the ninth decade of the twentieth century. It was the main reason why Montenegro adopted the Euro as its currency. Inflation is the rate at which the general level of prices is rising record high levels in economies where demand for goods and services outstrips productive capacity leading to upward pressure on prices. Even after

adopting hard currency inflation, an inertia effect was present in Montenegro for the period of three years as can be seen in the next table.

Table 6 Inflation rate in Montenegro from 2000 to 2005¹⁴

	2000	2001	2002	2003	2004	2005
Annual Inflation rate in %	24.8	28	9.4	6.7	4.3	1.8

If we take a look at the period from 2002 to 2005 (that is the period since Euro became legal tender in Montenegro) we will see that two important macroeconomic indicators show significant improvement.



Foreign investors look for the interest rate in a domestic banking system since, as Bodie et al (2005) nicely explained, high interest rates reduce the present value of future cash

¹⁴ Data in table are presented as given by the Central Bank of Montenegro at its web site <http://www.cb-mn.org>.

flows, thereby reducing the attractiveness of investment opportunities. Interest rates in Montenegro are very high because of several reasons. The first is that demand outstrips supply. The second is that the Montenegrin Government actively sold its T-bills at the market thus attracting available funds from banks especially as those securities offered high yields (although that changed during 2005). The situation is changing since two major European banks entered the Montenegrin market and several more announced their arrival.

Connected to the previous paragraph is the Budget Deficit issue. Budget deficit created by the government must be covered by borrowing. Large amounts of government borrowing force up interest rates by increasing the total demand for credit in economy and thus they are pushing out private borrowing and cutting available funds for business investments. Budget deficit in Montenegro varies in the period from 2002 to 2005, but the foreign donations that helped the Montenegrin economy over the past five years declined too. According to MIPA (2005) the budget deficit of Montenegro in 2002 was 1.93% of the GDP, in 2003 was 3.16% of GDP and in 2004 was 2.10% of GDP with estimation of 1.6% of GDP in 2005.

The capital market in Montenegro has developed during the past decade and currently two stock exchanges operate on the Montenegrin capital market. Three types of securities are currently traded on the Montenegrin capital market: shares of companies, shares of privatization-investments funds and so called “old-foreign-currency-savings bonds”¹⁵. There are eight broker houses and one dealer house operating on Montenegrin stock exchanges.

The total volume of trade according to MIPA (2005) on both Montenegrin stock exchanges in the first eight months of 2005 was over 114,6 millions of Euros, which is more than twice the total volume in 2004. It can be safely concluded that more and more trade in Montenegro is done through regulated markets. The Securities Commission of Montenegro is in charge of regulating capital markets in Montenegro. The Central Depository Agency oversees the deposit of dematerialised securities, clearing and settling securities transactions and other activities related to dematerialised securities.

4.1. Comparative advantages of Montenegro

Montenegro has some very distinct comparative advantages for the foreign investor and some of them are: location, climate, low real estate prices, well educated and relatively cheap work force, low taxes, and low currency risk. The State Union of Serbia and Montenegro has free trade agreements with most of neighbouring countries in the Balkans and with Russia. Total investments from 1997 to 2004 amounts to 420 millions of Euros, most of them were M&A (National Petrol Company, Telecom, Aluminium plant, three banks) and green field operations (Norwegian company for mobile phones, two banks).

¹⁵ These bonds are debt instruments issued by the government for using foreign exchange savings of citizens in past two decades.

4.1.1. Location

Montenegro is located at the Adriatic Sea across Italy and it is only 2 hours flight away from London, Paris or Berlin and one hour from Rome, Vienna or Budapest. It is connected to other countries by railroads and roads and it has one major port, city of Bar.

Tourism is one of the industries that should grow more rapidly than competing countries. The Financial Times (2005) reported that State tourism authorities say foreign visits are set to boom, on the strength of the country's political stabilisation and the recent return of British, European and Russian enthusiasts and that analysts at the London based World Travel Tourism Council (WTTTC) concur. They say that tourism already accounts for 14.8 per cent of gross domestic product, providing more than 22,000 jobs. The WTTTC predicts that the sector will triple in real terms during the next decade, making Montenegro the world's fastest growing tourism market as measured by the sector's share in the overall economy. It is forecast to grow twice as fast as tourism in Turkey or Greece and three times faster than Italy, just across the sea.

4.1.2. Low Real estate prices

When educated investors look for opportunities this search usually starts with basic environment conditions. One of the basics is real estate prices. Comparing the situation in Montenegro with neighbouring countries it is easy to spot that prices of real estate in Croatia were rising sharply in the last few years. The beautiful Adriatic coast, relatively safer than some other Mediterranean countries, became very attractive for investors. But Croatia does not have beaches like Montenegro and it made restrictions for foreigners wishing to purchase property. So educated investors started looking in Montenegro and what they saw impressed them. They noticed an even more gorgeous part of the Adriatic coast with solid infrastructure and much cheaper than Croatia.

4.1.3. Low labour costs

Montenegro has a well-educated work force but unfortunately a high unemployment rate. On the other hand that represents a chance for foreign investors to obtain cheap labour for more sophisticated jobs. According to the Government Statistical Office (MONTSTAT) there are more than 1000 graduates every year in Montenegro. The University of Montenegro has 14 different faculties and one higher school and recently several private colleges were founded. The average monthly salary in Montenegro is around 300 Euros gross and minimum wage is set to be 50 euros. The fact that prices of labour are lower than the EU average prompted US Commercial Service (2005) to recommend to US companies to invest in Serbia and Montenegro at their web site giving examples of several leading sectors for US export and investments.

4.1.4. Low taxes

The average customs rate in Montenegro is 6%. Corporate profit tax is only 9%¹⁶ and it is the lowest in Europe. Personal Income Tax (PIT) is up to 23% (at the moment it is too high but it is under consideration by the government for reduction and move from progressive to proportional tax rate¹⁷). Real estate taxes vary from 0.08% to 0.8% a year and they are under the jurisdiction of local governments. There are double taxation treaties (with United Kingdom and many other countries) that should prevent tax losses

¹⁶ This claim is made by MIPA (2005) quoting "Forbes Magazine's Tax Misery Index 2004" as the source.

¹⁷ This should be regulated through amendment to the Law and by issuing appropriate enabling regulations.

to foreign investors. Additionally it takes only 4 working days to register a new business with minimal stamp duties. There are three rates of Value Added Tax (VAT) in Montenegro: 0%, 7% and 17%. VAT turnover period is 30 days.

4.1.5. Low Currency risk

As previously mentioned Montenegro adopted the Euro as currency. With the inflation rate down at the European Union zone currency, risk is negligible. Foreign banks operating in Montenegro can be used for transfers of profit or business without restriction excluding money-laundering regulations.

Investing in Montenegro is possible for legal entities and private individuals. There are no limits for investments sizes and no real restrictions, since foreigners can acquire rights to real estates, like company facilities, apartments and land for construction and additionally foreign citizens can claim property rights over real estates by inheritance in the same manner as local citizens. Transfers of funds can be done without restrictions after fulfilling obligations like income taxes and similar. There is no tax discrimination of foreign investors compared to domestic citizens.

The World Bank (2005) in its Report states that privatisation is still not over and there are issues regarding already privatized companies. Many of those privatized companies need additional investments in order to start to operate efficiently since their equipment is outdated and their assets need reconstruction. It is also necessary to invest in education and acquire managerial expertise of the local work force. The local work force is usually well educated with good capacity but without practical knowledge and up-to-date training.

In some occasions some economists considered that every investment from foreign countries into state owned companies represents a privatisation, but in Montenegro, for example the biggest local bank has been bought by the biggest Slovenian bank, which was owned by majority shareholders representing the Slovenian government. Is it privatisation when one government owned body acquires another government owned body in another country? Of course not, but for this research it is the flow of capital coming from another country that counts.

4.2. Investments examples in real life

According to the web site of the Montenegrin Investment Promotion Agency (<http://www.mipa.cg.yu>) the following are major foreign investment success stories:

TELENOR Mobile Communication AS, Norway is 100% owner of the first and biggest mobile phone operator in Montenegro, PROMONTE (founded 1996, this company was also one of the first foreign investments in the Republic of Montenegro after Balkan wars). It made the biggest Greenfield investment in Montenegro thus far, buying shares for € 64,8 millions and investing additionally € 83 millions to date. PROMONTE has 225 employees and operating with considerable profit since its foundation.

Greek Company Hellenic Petroleum S.A. purchased 54.4% shares of the state owned National Petroleum Company JUGOPETROL for € 65 millions and invested additional € 35 millions. The company expanded its activities in Montenegro and in neighbouring

Bosnia and Herzegovina and the Kosovo province of Serbia. It also explores for natural gas reserves in the territory of Montenegro and off its shores.

HIT Group Slovenia purchased hotel MAESTRAL for € 4.5 millions and invested a lot more money to make it 4 stars hotel. According to the latest newspapers headlines, they have received an offer of € 60 millions to sell the hotel to a group of investors from Russia.

Japanese Company Daido Metal purchased and invested over € 9 millions in Ball Bearings Plant in Kotor. Daido is the world leader in production of lubricated bearing production (used for automobiles, shipping and other industries). It has € 3,8 billions of capital and 1260 employees worldwide.

INTERBREW from Belgium purchased Niksic Brewery (established in 1896) and in total invested € 21 millions introducing new product lines, new packages and spreading domestic products to other markets.

Hungary's Magyar Telecom (owned by Deutsche Telecom) purchased 51% of shares of state owned TELECOM Montenegro for € 22 millions. It has plans to invest a lot more in next five years in order to modernise the company and include it in its system. As Financial Times (2005) reported, Hungary's Magyar Telecom paid €114m for the state's 51.1 per cent share in Telekom Crne Gore, the fixed line telecommunications company the revenues of which last year equalled 6.6 per cent of Montenegro's economic activity. Magyar then raised its overall stake to 73 per cent, paying € 22.9 m to minority shareholders.

Financial Times (2005) also reported on the sale of the KAP¹⁸, presenting that four bidders showed interest, but one held out to the end - Russia's Rusal, which through Cyprus-based Salamon Enterprises, reached a \$235m deal. Along with a €48.5m base purchase price and an additional \$27m owed to the state, Rusal must pay for a €55m investment plan, to be matched by \$20m from KAP's budget. Rusal also assumes responsibility for KAP's debts.

Recent important investments by financial institutions in the Montenegrin banking and financial system were:

NLB Group from Slovenia (owned 34% by Belgium Bank KBC) purchased the state owned Montenegro Bank in 2003 and foreign owned bank EUROMARKET¹⁹ bank in 2005 in order to develop dominant bank in Montenegro. New merged Bank has € 21 millions of capital and holds 20% of Montenegrin market. EBRD has approximately 8% of stake in this bank and 5% small shareholders.

French bank SOCIETE GENERALE GROUP purchased 74.73% of shares of state owned bank -PODGORICKA bank in 2005 and Austrian Bank HYPO-ALPE-ADRIA plans to open its bank in 2006.

¹⁸ KAP is the biggest Montenegrin plant that produces 120,000 tones of aluminium annually.

¹⁹ EUROMARKET bank was founded in 2001 as the first bank in Montenegro that was fully owned by foreign entities. Major shareholders were SOROS Fund and EBRD.

All other banks in Montenegro are at least partially (usually majority owners are from foreign countries) owned by foreign investors except NIKSICKA and PLJEVALJSKA banks, which should be privatised in 2006.

Privatisations in Montenegro were done in one of three forms: auction sale, tenders and direct negotiations. Part of the shares in state owned companies were given to all citizens in the form of vouchers. The privatisation of Montenegro Bank was done in late 2002 and beginning of 2003 with technical help from British DFID²⁰ experts with advertisement for share sale in local and international papers. The bank set up a data room available for foreign buyers in order to facilitate their due diligence purposes. The General Manager during privatisation was a DFID expert and additionally one more foreign adviser was sitting in the Managing Board.

Finally, I will present the latest news from a Montenegrin daily “Vijesti” as of 3rd of March 2006: it was published that Swiss company ASG, American company First Boston Capital and American investment fund SECI talked with the Government of Montenegro on investing 2 billion US dollars in a power plant working on natural gas to be built in Southern Montenegro. Delegations of companies Nortel and Motorola announced their coming to Montenegro in the next few months in order to invest in this Republic. The budget airways company “Ryan Air” from Ireland also plans to enter the Montenegrin market and apparently they had a discussion over their plan with the Government of Montenegro.

In order to achieve this purpose, after completion of the research, this paper should be able to recommend the following Policy Recommendations.

4.3. Policy Recommendations

John Maynard Keynes said “In the long run we are all dead”, which is the reason that I am reluctant to propose any long term policy recommendations, but in a case of macroeconomic issues that include the creation of an environment attractive to foreign investments it is necessary to consider at least a 5 years horizon. It is reasonable to expect that business conditions and economic environment would not change dramatically within 5 years.

The following are recommendations for policy makers in Montenegro and they should take all necessary measures to accomplish them.

Recommendation 1: find a way to attract foreign investors who are willing to invest in Montenegro (venture capitalists, organizations that search for highly qualified but less expensive work force in the proximity of the European main destinations, donor organizations that search for a way to improve the standard of living in countries candidates for accession into EU etc).

Recommendation 2: present, in an appropriate way, investment opportunities that would be both profitable for foreign investors and useful for development of local economy with

²⁰ Department for International Development (DFID) is the organization of UK government that manages UK's help to developing countries.

an objective to quickly find at least three attractive investment opportunities that may be competitive at the world market.

Recommendation 3: find an efficient manner of bridging local and foreign investors views on business strategy and merge potentially diverged interests into a harmonized joint policy.

Recommendation 4: the government should establish capital flow control in such a way that it can stimulate long-term capital and avoid mistakes done by Asian countries that experienced financial crises in nineties.

Guidelines for foreign investors:

Recommendation 1: One way of operation may be to appoint a foreign manager as the general manager accompanied with a domestic deputy manager; Board of directors should have a majority of foreign directors and educate local management as fast as possible and give them necessary tools for further development of their careers.

Examples of more detailed goals to achieve related to this recommendation will include answers to some additional issues that sometimes take too much time at the field like: Why is it that the complex issues of investing in foreign countries are always attempted to be resolved by simple solutions? Is it because there is a common belief that only simple solutions are genius ones? An array of simple solutions for parts of problems maybe the right thing to do, but the experience shows that complex problems are usually exactly that – complex problems with a lot of considerations to be taken into account. It is also very important to tackle very fundamental Interpretation-translation issue as well as communication issues.

Recommendation 2: establish a system of fast resolution of disputes regarding working conditions, social protection and realization of attractive profit level and set up a body, which will determine managerial roles and responsibilities

Recommendation 3: Take more time preparing the arrival into the country and do not forget to include the domestic work force even in this early period of undertaking investment activities.

While working for international institutions I have noticed that many foreign advisors, consultants and managers are not prepared to adapt to cultural and social differences and simply do not know how to behave when confronted with problems in communication to local counterparts.

The most frequent mistakes are: foreigners tend to underestimate the competence and knowledge of local counterparts; they tend to treat local counterparts as someone who is obliged to fulfil all of their wishes; they tend to distance themselves socially from locals.

Locals on the other hand, tend to underestimate the competence and the knowledge of the foreigners, but also sometimes tend to overestimate the expertise and knowledge of foreigners treating them like someone who has answers for every question (on some occasions it is just because usually poorly paid locals don't want to do anything, as they consider foreigners would provide all answers without their participation).

5. Concluding remarks

We have concluded that an increase of foreign direct and portfolio investment will increase chances of Montenegro becoming a representative case and probably aid other South-Eastern European Countries' successful accession into the European Union. This is based on the fact that all these countries are adjusting their legislature and economic and politic systems in order to attract investments and as a consequence are adjusting those to European Union standards.

Further investment will bring an additional opening of the mentioned countries and improvement of their standard of living. Investment will bring not just fresh capital but the transfer of technology and modern management practices and establish links across the Europe.

New networks of inter European contacts will provide new opportunities for businesses and joint ventures that cannot be seen now, but will naturally develop from these links. This will become a continuing part of the process of developing economies and societies of these countries and their moving towards accession to the European Union.

The first part of this paper introduced basic definitions related to issue of foreign investments. This was done by using modern up-to-date banking and finance literature with an accent on direct foreign investments and portfolio investments. Resources included studies and databases of UNCTAD, World Bank and IMF as well as of Montenegrin and other researchers. In the second part it presented limits that may face possible investors while coming into Montenegro. Those limits include a variety of risks and restrictions regarding market size and political situation. This part provided some useful statistics and insight on the issue of risks.

However, the third part of this paper showed real opportunities that investor may use, and those opportunities can be long-term profitable solutions for them. This part contained a variety of statistical data about Montenegro. Additionally, good climate, hospitality of local people and proximity to major European centres may prove to be added value to an investment decision.

I believe that the basic thesis of this paper proves that Montenegro presents a good alternative in a variety of options available to investors today. I also believe that facts and data provided in this paper will facilitate the decision of investing in Montenegro.

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